



March 7, 2017

Dear Honorable Member of the Michigan Legislature,

On behalf of the Coalition to Stop Internet Gambling (CSIG), a national effort to oppose Internet gambling at the state and Federal levels, please allow me to state strong opposition to Senate Bill 203 through 205.

CSIG Opposition is based on the following:

- The federal legal framework driving the state by state initiative by proponents of internet gambling is a house of cards and very likely to be overturned by the newly appointed US Attorney General.
- The authorization of internet gambling as a form of gaming in Michigan would require not only a statewide ballot but elections in every city and township across the state, and could result in a regulatory nightmare.
- The authorization of internet gambling as a form of gaming in Michigan is a violation of compact agreements with federally protected Native American Tribal Casinos.
- SB 203 to 205 poses a threat to Michigan's state budget already under pressure.
- Supporters of internet gambling cannot insure the safety of the internet or that our children are prevented from access to gaming sites.

For these reasons, we ask you to stand up for the hardworking families of Michigan and vote NO on SB 203 through 205.

Very Truly Yours,

A handwritten signature in blue ink, appearing to read "Bill Jackson", written over a horizontal line.

Bill Jackson



# No Grandfather Clause For Internet Gaming

*If Trump Administration Reverses Obama Action, There Is No Grandfather Protection For States Who Authorized iGaming*



## AG Nominee To 'Revisit' Obama's Online Gaming Opinion

**SENATOR GRAHAM:** What's your view of the Obama Administration's interpretation of the Wire Act to allow online video poker or gambling?

**ATTORNEY GENERAL NOMINEE JEFF SESSIONS:** I was shocked at the memorandum, I guess the enforcement memorandum that the Department of Justice issued with regard to the Wire Act and criticized it. Apparently, there is some justification or argument that can be made to support the Dept of Justice's position. But, I did oppose it when it happened. It seemed to me to be unusual.

**SENATOR GRAHAM:** Would you revisit it?

**ATTORNEY GENERAL NOMINEE JEFF SESSIONS:** I would re-visit it. And, I would make a decision about it based on careful study.... (1/10/17, Senate Hearing)

## Internet gambling cannot be 'grandfathered'

Under the Obama Administration, the Department of Justice's Office of Legal Counsel (OLC) wrote an opinion offering a competing interpretation of legislatively established gaming laws. **Michigan cannot "grandfather" OLC Opinions.**

- 1) OLC Opinions do not carry force of law.
- 2) Courts do not defer to OLC Opinions and such opinions are not binding on courts.
- 3) OLC Opinions, if withdrawn, do not confer immunity to those who rely on the withdrawn opinion.
- 4) Regardless of the above, internet gambling is already illegal under four laws.





**CONFIDENTIAL ATTORNEY-CLIENT PRIVILEGE  
MEMORANDUM**

TO: Coalition to Stop Internet Gambling  
FROM: Warner Norcross & Judd LLP  
DATE: May 31, 2016  
  
RE: **Analysis of Senate Bills 889 and 890**

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**INTRODUCTION AND SUMMARY OF CONCLUSIONS**

On April 14, 2016, Michigan Senator Mike Kowall introduced SB 889, the Lawful Internet Gaming Act. The bill's purpose is to expand gambling in Michigan by legalizing and regulating online casino games and other forms of Internet gambling in the State of Michigan. This bill was introduced alongside SB 890, which would amend the gambling section of the Michigan penal code to create an exemption for Internet gambling authorized under SB 889. Absent this authorizing legislation, online gambling in Michigan is illegal under the federal Unlawful Internet Gambling Enforcement Act of 2006.

You have asked us to review SB 889 and SB 890 as introduced and assess their constitutionality. The bills—particularly SB 889—violate numerous provisions of the Michigan and United States Constitutions, including the following:

- Article 4, § 41 of the Michigan Constitution
- Imposition of unreasonable licensing and application fees
- Separation of powers

The most critical of these violations is Article 4, § 41, which provides that no new Michigan law authorizing gaming is effective without the approval of a majority of voters in both a statewide election *and* the city or township where gambling will take place. Because Internet gambling is likely to take place everywhere, there is a strong argument that a majority vote within every single Michigan city and township is necessary to make SB 889 and SB 890 effective.

In addition, although not *per se* constitutional violations, the bills raise a number of practical problems, including exempting from FOIA disclosure information obtained pursuant to the Lawful Internet Gaming Act, and requiring tribes to waive their sovereign immunity to participate in Internet gaming.

## BACKGROUND

### Legal Gambling in Michigan

Michigan first opened the door to gambling as the State tried to deal with the financial ramifications of the Great Depression. On June 28, 1933, Governor William A. Comstock signed the Racing Act of 1933 to authorize and regulate pari-mutuel horse racing in Michigan. Pari-mutuel betting remained the only state-sanctioned gambling authorized anywhere in the country for the next 30 years, until New Hampshire became the first state to authorize a state lottery in 1963. Several states followed New Hampshire's lead, and in 1972—again under pressure to balance the state budget—Michigan amended its constitution through a ballot referendum to “authorize lotteries and permit the sale of lottery tickets in the manner provided by law.” Const 1963, art 4, § 41. Later that year, the Michigan Legislature created the first state lottery, see MCL 432.1 *et seq.* and authorized charitable gambling a short time later, see MCL 432.101 *et seq.*

The first tribal casino opened in Michigan in 1984, and four years later, Congress enacted IGRA, the Indian Gaming Regulatory Act, which authorized tribes to open casinos after successfully negotiating a gaming compact with the state. See 25 USC 2701 *et seq.* A proliferation of new tribal casinos followed, some of which continue to pay the Michigan Strategic Fund and the Michigan Economic Development Corporation pursuant to the revenue-sharing formula in their state compacts, and some of which do not. See Michigan Gaming Control Board, Payments to MSF or MEDC as of 3/3/2016 <[http://www.michigan.gov/documents/8\\_percent\\_Payments\\_76616\\_7.pdf](http://www.michigan.gov/documents/8_percent_Payments_76616_7.pdf)> (accessed May 31, 2016).

In 1996, Michigan voters passed another statewide referendum that expanded legalized gambling in the State by authorizing limited casino gambling in Detroit. Proposal E. Initiated Law 1 of 1996 (codified at MCL 432.201-432.226). The Legislature responded by creating the Michigan Gaming Control Board. MCL 432.204. The Board has no authority over tribal casinos but does regulate the three casinos that currently operate in the City of Detroit.

### Proposal 1

By the early 2000s, horse-racing tracks sought legislative approval to expand on-site gambling to include slot machines, off-track racing theaters, and account wagering. The tracks persuaded the Michigan Senate and House of Representatives to pass bills to that effect in 2004. But before the bills were enacted, another referendum initiative involving gambling appeared on the 2004 general-election ballot as Proposal 1. The official ballot language appeared as follows:

#### PROPOSAL 04-1

A PROPOSAL TO AMEND THE STATE CONSTITUTION TO  
REQUIRE VOTER APPROVAL OF ANY FORM OF  
GAMBLING AUTHORIZED BY LAW AND CERTAIN NEW  
STATE LOTTERY GAMES

The proposed constitutional amendment would:

- Require voter approval of any form of gambling authorized by law after January 1, 2004.
- Require voter approval of any new state lottery games utilizing “table games” or “player operated mechanical or electronic devices” introduced after January 1, 2004.
- Provide that when voter approval is required, both statewide voter approval and voter approval in the city or township where gambling will take place must be obtained.
- Specify that the voter approval requirement does not apply to Indian tribal gaming or gambling in up to three casinos located in the City of Detroit.

Should this proposal be adopted?

Yes

No

Michigan voters approved the proposal, thus amending article 4, § 41 of the state constitution to add the following italicized language:

*The legislature may authorize lotteries and permit the sale of lottery tickets in the manner provided by law. No law enacted after January 1, 2004, that authorizes any form of gambling shall be effective, nor after January 1, 2004, shall any new state lottery games utilizing table games or player operated mechanical or electronic devices be established, without the approval of a majority of electors voting in a statewide general election and a majority of electors voting in the township or city where gambling will take place. This section shall not apply to gambling in up to three casinos in the City of Detroit or to Indian tribal gaming.* [Const 1963, art 4, § 41 (Proposal 1).]

In 2006, the Michigan Attorney General opined that Proposal 1 does not apply to games that the Commissioner of the Bureau of State Lottery may authorize pursuant to the Traxler-McCauley-Law-Bowman Bingo Act (MCL 432.101 *et seq.*), which authorizes charitable organizations to conduct games of chance under specified conditions (such as bingo, raffles, millionaire parties, and the like). OAG, 2006, No. 7190, 2006 WL 690823.

Two years later, in May 2008, several horse-racing tracks filed a federal lawsuit seeking a declaration that Proposal 1 violated the federal Constitution. The United States Court of Appeals for the Sixth Circuit rejected those claims in 2010 and upheld the constitutionality of Proposal 1. *Northville Downs v Granholm*, 622 F3d 579 (CA 6, 2010).

## **Proposed "Lawful Internet Gaming Act"**

Senate Bill 889 would allow Internet wagering carried out in accordance with the proposed Lawful Internet Gaming Act. Among other things, the Bill creates a Division of Internet Gaming within the existing Michigan Gaming Control Board, and allows the Division to issue up to eight Internet gaming licenses if applicants meet certain criteria, pay a \$100,000 application fee, and pay a \$5 million license fee in the form of an advance payment of the applicant's Internet wagering taxes. Those taxes would be assessed as a 10% cut of gross gaming revenue received by an Internet gaming licensee from Internet gaming authorized under the Act.

Senate Bill 890 would amend the Michigan Penal Code to exclude activities authorized by the Lawful Internet Gaming Act from Chapter XLIV of the Code, which prescribes certain penalties for illegal gambling activities taking place with the State of Michigan.

Each bill would purportedly take effect 90 days after enactment. The bills are tie-barred.

## **CONSTITUTIONAL ANALYSIS**

### **I. Article 4, § 41**

As noted above, the people of Michigan amended the Constitution through the referendum process by enacting Proposal 1 in 2004. The Proposal added the following words to the existing Article 4, § 41 of Michigan's Constitution:

No law enacted after January 1, 2004, that authorizes any form of gambling shall be effective, nor after January 1, 2004, shall any new state lottery games utilizing table games or player operated mechanical or electronic devices be established, without the approval of a majority of electors voting in a statewide general election and a majority of electors voting in the township or city where gambling will take place. This section shall not apply to gambling in up to three casinos in the City of Detroit or to Indian tribal gaming. [Const 1963, art 4, § 41 (Proposal 1).]

The Lawful Internet Gaming Act falls easily within the scope of Proposal 1, satisfying both of Proposal 1's prerequisites.

First, if passed and signed into law, the Lawful Internet Gaming Act would be a "law enacted after January 1, 2004." Second, the Act would unequivocally authorize a "form of gambling," specifically, Internet gambling. Accordingly, the Act triggers Proposal 1's proscription: the Lawful Internet Gaming Act will not be effective "without the approval of a majority of electors voting in a statewide general election and a majority of electors voting in the township or city where gambling will take place." As a result, that portion of the Act that states the Act will "take[ ] effect 90 days after the date it is enacted into law" violates art 4, § 41 of Michigan's Constitution and is invalid.

To become effective, the Act would, at a minimum, require an affirmative vote of approval by “a majority of electors voting in a statewide general election.” But there is a strong argument that the Act would also require approval of “a majority of electors voting” in *every* Michigan “township or city where gambling will take place.”

When Michigan voters approved Proposal 1, they presumably contemplated a general prohibition on traditional brick-and-mortar casinos. So if a new casino was proposed for the City of Lansing, that casino would require approval by a majority of voters both in a statewide election *and* in a City of Lansing election. But Proposal 1’s plain language is not limited to brick-and-mortar casinos and applies equally on its face to the creation of an Internet casino. For example, if it is anticipated that an Internet casino’s customers will participate in Internet gaming from their homes in Detroit, Lansing, and Grand Rapids, then “gambling will take place” in Detroit, Lansing, and Grand Rapids. Accordingly, Proposal 1 requires an affirmative vote by a majority of electors voting in each one of those cities *in addition to* an affirmative statewide vote. If the voters in Detroit and Lansing approve of the proposal and voters in Grand Rapids turn it down, then the Act would not be effective in Grand Rapids. In other words, any casino that receives a license for Internet gaming would have to calibrate its software in such a way so as to prohibit anyone from engaging in Internet gaming from a Grand Rapids location (or any other location where local voters declined to authorize Internet gaming) or risk being charged with conducting illegal gaming in Grand Rapids.

There is nothing in Proposal 1’s text that contemplates a bypass around the requirement that local voters approve a proposed expansion of gambling within the State when gambling will take place in a particular locality. The only way to avoid the local-voting requirement would be a new constitutional amendment that modifies § 41’s plain language. Indeed, the unlikelihood of obtaining an affirmative vote for Internet gaming by every local township and city within the State, combined with the practical difficulty of operating an Internet casino with multiple jurisdictional “holes” within the State’s borders, might render SB 889 and SB 890 ineffective absent such a constitutional amendment.

Proponents of SB 889 and SB 890 have suggested that Proposal 1 may be inapplicable here to the extent that it is a Detroit casino or tribal casino that seeks a license for internet gaming. This suggestion is based on the last sentence of article 4, § 41, which reads: “This section does not apply to gambling in up to three casinos in the City of Detroit or to Indian tribal gaming.” The problem with the proponents’ argument is that it places the proverbial cart before the horse. There is no such thing as an “internet gaming license” in Michigan unless and until SB 889 and SB 890 are signed into law. And SB 889 and SB 890 facially violate Proposal 1 by purportedly authorizing internet gambling without the requisite statewide and local votes discussed above. Just because the three Detroit casinos and tribal casinos could apply for one of the eight internet gaming licenses contemplated by SB 889 *after* SB 889 becomes Michigan law does not mean that SB 889 *as proposed* complies with article 4, § 41. In fact, the opposite is true: SB 889 on its face falls squarely within the broad provisions of Proposal 1’s plain text. Accordingly, SB 889 must satisfy the electoral procedures that Proposal 1 outlines for gaming laws enacted after January 1, 2004.

Some may question how the Michigan Lottery could expand to online gaming without satisfying Proposal 1’s statewide and electoral requirements. The simple answer is that no one

stepped forward and challenged that expansion under Proposal 1. But even if such a challenge had been made, it is not clear that the Michigan Lottery's use of online gaming would fall within Proposal 1's scope. To trigger the electrical procedures in Proposal 1, a new state lottery game must involve "table games or player operated mechanical or electronic devices." Const 1963, art 4, § 41. Online lottery games are not "table games" or "mechanical . . . devices." And it would be strange to describe the Internet itself as an "electronic device[ ]." Accordingly, if challenged, the Michigan Lottery would have a strong, plain-language defense to its expansion of the state lottery to include online gaming.

ccurring. As a result, § 11 violates procedural due-process requirements.

## **II. Imposition of Licensing and Application Fees**

The licensing and application fees imposed by SB 889 arguably create constitutional problems because they provide the Division with unbridled discretion to impose these fees, which can limit an institution's ability to engage in protected First Amendment expression through advertising. The United States Supreme Court has long held that a licensing fee which prevents a person from engaging in expression under the First Amendment cannot be imposed in an arbitrary manner. *Murdock v Pennsylvania*, 319 US 105, 116 (1943). Specifically, an inquiry into the constitutionality of a fee ordinance is two-fold: (1) does the regulation in question vest the public officials in charge of enforcing or applying the ordinance with a constitutionally impermissible amount of discretion, see, e.g., *Forsyth Co v Nationalist Movement*, 505 US 123, 130-132 (1992), and (2) is the fee amount based upon the costs of administering the ordinance, maintaining public order, and relieving the other burdens on public services stemming from the matter licensed, see *Cox v New Hampshire*, 312 US 569, 576-577 (1941); *Murdock*, 319 US at 116.

SB 889 imposes a significant \$100,000 application fee and an enormous \$5 million license fee. 2016 SB 889, §§ 6(7) & (14). These fees are imposed by the Division without any restrictions and could prevent an institution from being able to express its First Amendment rights allowed under the Act. As the Supreme Court has held, a "state may not impose a charge for the enjoyment of a right granted by the Federal Constitution." *Murdock*, 319 US at 114.

There is no First Amendment right to gamble, but the proposed bill also applies to advertising, which would undeniably fall within the scope of the First Amendment. As such, the imposition of these fees is similar to the license fee imposed in *Murdock*, which the U.S. Supreme Court struck down as an impermissible restriction on the free exercise of rights protected under the First Amendment. In *Murdock*, a city imposed a license fee for persons who wished to solicit or canvass within the city limits. *Id.* at 106. The Court struck down the license fee, holding that it was not a nominal fee, it was not apportioned in accordance with petitioners' revenue, and it unreasonably restricted their ability to engage in First Amendment activity by going door-to-door and soliciting donations for their religious institution. *Id.* at 113.

Likewise, the fees imposed under SB 889 are not nominal fees, are not apportioned in accordance with the licensees' revenue, and would unreasonably restrict the licensees' ability to advertise Internet gaming if they could not afford to pay the fees. Although the bill attempts to apportion the fees by stating that a "license fee imposed by this section is an advance payment of

Internet wagering taxes owed by the Internet gaming licensee under section 12,” 2016 SB 889, § 6(14), this provision actually creates more problems than it solves. Indeed, depending on the revenue obtained as a result of Internet wagering, this provision could create a situation in which the \$5 million license fee is still being used to pay taxes for a licensee decades in the future. As a result, prior to the conduct occurring, it is impossible to assess whether these fees are proportionately related to the revenues stemming from Internet gaming, and the Legislature offers no supporting evidence for such proportionality.

Ultimately, these fees vest an impermissible amount of discretion in the Division, are not properly related to the costs of administering the proposed law, and could restrict potential licensees from engaging in protected First Amendment activity. Accordingly, the imposition of these large fees is impermissible under the First Amendment to Michigan’s Constitution.

### III. Separation of Powers

Section 8(c) of SB 889 implicates a serious separation of powers problem under the Michigan Constitution. The Michigan Constitution divides the government “into three branches: legislative, executive and judicial” and states that “[n]o person exercising powers of one branch shall exercise powers properly belonging to another branch except as expressly provided in this constitution.” Const 1963, art 3, § 2. “This separation of powers is designed to preserve the independence of the three branches of government.” *In re “Sunshine Law,”* 1976 PA 267, 400 Mich 660, 662; 255 NW2d 635 (1977); see also *Wood v State Admin Bd*, 255 Mich 220, 225; 238 NW 16 (1931) (“This historical and constitutional division of the powers of government forbids the extension, otherwise than by explicit language or necessary implication, of the powers of one department to another.”).

Article 6, § 5 of the Michigan Constitution reserves to the judicial branch the power to “establish, modify, amend and simplify the practice and procedure in all courts of this state.” Const 1963, art 6, § 5. In accordance with separation-of-powers principles, the judicial branch’s authority in matters of practice and procedure is exclusive and therefore beyond the Legislature’s power. *People v Watkins*, 491 Mich 450, 472; 818 NW2d 296 (2012). This exclusive authority extends only to rules of *procedure*, as courts have no power to enact court rules that establish, abrogate, or modify the *substantive* law. *Id.*

Section 8(c) of SB 889 gives the Division the ability to conduct hearings pertaining to civil violations of the Act. In defining the scope of these hearings, § 8(c) states: “In a hearing under this subdivision *or in a court action*, a reproduced copy of a record of the division relating to an Internet gaming licensee or Internet gaming vendor . . . *must be admitted into evidence* and is prima facie proof of the information contained in the record.” 2016 SB 889, § 8(c) (emphasis added). By directing a judge to admit a certain kind of evidence without regard to the Michigan Rules of Evidence, § 8(c) usurps the judiciary’s role in establishing the rules of practice and procedure as provided for in Article 6, § 5.

To properly assess whether § 8(c) violates the separation-of-powers principle, a court would apply the test adopted in *McDougall v Schanz*, 461 Mich 15; 597 NW2d 148 (1999). In *McDougall*, the court created an approach to separate procedural rules—which are left to the judicial branch—from substantive rules—which are created by the legislative branch. Under the

*McDougall* test, statutory rules of evidence that reflect policy considerations limited to “the orderly dispatch of judicial business,” i.e., court administration, are procedural and violate Article 6, § 5. *Id.* at 31. But statutory rules of evidence that reflect policy considerations “over and beyond matters involving the orderly dispatch of judicial business” are substantive and thus do not violate the separation of powers principle. *Id.*

Here, § 8(c) is concerned primarily with court administration because it divests a court of its ability to weigh the evidence to determine whether it should be admitted. See MRE 403 (giving courts the discretion to exclude evidence where its probative value is outweighed by its prejudicial effect). Unlike in *Watkins*, where there was an overriding interest in protecting rape victims, there is no apparent overriding policy consideration present here. In other words, there is no prevailing need to protect the public from civil violations of SB 889 by requiring courts to admit evidence of a record of the division relating to a licensee or vendor. Rather, this provision merely usurps the judicial role in determining when evidence should be properly admitted. As a result, § 8(c) violates the separation-of-powers principle with respect to Article 6, § 5 of the Michigan Constitution.

## **PRACTICAL CONSIDERATIONS**

### **I. FOIA Disclosure Requirements**

In addition to potentially violating the Michigan and United States Constitutions in multiple ways, SB 889 and SB 890 are also problematic for other, more practical reasons. For instance, SB 889 exempts information gathered under the Act from disclosure under Michigan’s Freedom of Information Act (“FOIA”). The FOIA statute sets forth requirements for public access to public records. Pursuant to FOIA, each public body must provide a requesting person with a reasonable opportunity for inspection and examination of public records. MCL 15.233. A public record is defined as “a writing prepared, owned, used, in the possession of, or retained by a public body in the performance of an official function, from the time it is created.” MCL 15.232(e).

SB 889 exempts from disclosure under FOIA information that is gathered or retained under SB 889. For example, under § 6(8), “information, records, interviews, reports, statements, memoranda, or other data supplied to or used by the division in the course of its review or investigation of an application for an Internet gaming license or a renewal of an Internet gaming license” are exempted from FOIA disclosure requirements. 2016 SB 889, § 6(8). Likewise, “information, records, interviews, reports, statements, memoranda, or other data supplied to or used by the division in the course of its review or investigation of an application for certification as an Internet gaming vendor” are also exempt from FOIA under SB 889. *Id.* § (7)(6). Finally, the self-exclusion list and responsible-gaming database are exempt from FOIA as well. *Id.* § (11)(7).

There is nothing facially wrong with such exemptions; FOIA specifically allows public bodies to exempt certain records from disclosure. See MCL 15.243. But the exemptions take the Act in the exact opposite direction of the public’s increased interest in *expanding* disclosure

of documents retained by government agencies, not contracting them. As a result, exempting documents from disclosure under FOIA will likely lead to increased public skepticism and uncertainty regarding Internet gaming.

## **II. Waiving Sovereign Immunity; Impact on Existing Tribal Compact**

Another practical problem with SB 889 is that it requires tribes to waive their sovereign immunity to participate in Internet gaming under the Act. Specifically, § 6(4)(b) states: “The division shall not issue an Internet gaming license under this subdivision unless the Indian tribe, in connection with its application to conduct gaming under this act, waives its sovereign immunity with respect to conducting gaming under this act and paying fees and taxes imposed under this act.” 2016 SB 889, § 6(4)(b). Although it is not constitutionally prohibited to require a tribe to waive its sovereign immunity to obtain a state regulatory benefit, it is expected that tribes will be hesitant to comply with this provision, creating issues for the bill’s implementation.

Enacting SB 889 could also have a significant negative impact on the revenues the State currently receives from tribal casinos. Under IGRA, a tribe may not open a casino in a state that generally prohibits gaming (like Michigan) unless it enters into a compact with the state where the casino operates. Every tribal casino in Michigan operates has a compact with Michigan. These compacts provide that the tribe must pay 8% of its net win to the Michigan Strategic Fund or Michigan Economic Development Corporation. In exchange, the State promises the tribe certain “exclusivity,” i.e., that the State will not authorize a nearby casino. When the three Detroit casinos opened, a number of tribes claimed a breach of the promised exclusivity and stopped making their revenue-sharing payments, costing the State hundreds of millions of dollars. Tribes that still pay their 8% revenue sharing would likely make the same argument if SB 889 becomes law, causing the State to lose hundreds of millions of dollars more. The Senate Fiscal Agency’s Bill Analysis addresses this concern, noting that the effect could be similar to what occurred when tribes declined to pay their revenue-sharing payments due to the opening of the three Detroit casinos and the lottery’s Club Keno game. Because the Senate Fiscal Agency Bill does not provide specifics, it is not clear whether the revenue generated by SB 889 online licenses would exceed monies lost as a result of tribes terminating their revenue-sharing payments to the State.

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# Meliora Solutions, LLC

To: Bill Jackson  
McAlvey Merchant & Associates

From: Matt Hanley

Date: November 8, 2016

Re: Potential impact of online gaming on commercial casino revenue

You have asked me to analyze the proposal to allow online gaming in Michigan with respect to potential impacts on state revenues, especially those from the three commercial casinos in Detroit and the state lottery. Please see the below discussion, including responses to specific questions you have asked.

## **Background**

Michigan currently authorizes several forms of legal gambling in the state including the state lottery, commercial casinos, and pari-mutuel betting. In addition, several Native American tribes operate casinos in the state. Senate Bill 889 would permit online gaming in the state, subject to several restrictions.

A significant question for policymakers is what impact the new form of gaming would have on existing forms. There are three possible effects:

- Positive – In theory, the legalization of internet gambling could increase the amount spent on other types of gambling. When consumption of one good increases the consumption of another, the goods are referred to as “complimentary goods.”
- Neutral – It’s possible that the consumption of one good is unrelated to the consumption of another, and the increased consumption on the first has no impact on the level of consumption of the other.
- Negative – It is also possible that spending on existing casino gambling could suffer because of the existence of another form of gambling such as online gaming. If consumption of one good comes at the expense (in whole or in part) of another, the two goods are said to be “substitute goods.”

In addition to the consumption relationship discussed above, policymakers must also consider the tax rates that apply to each good. If a new form of gambling

has a neutral or complimentary relationship with an existing form, tax revenues will increase (resulting from the tax on the new product, and perhaps from the tax on the existing product). If two goods are substitutes for each other, however, the state may experience a gain or loss of revenue depending on the amount of substitution that takes place and the difference in tax rates.

The Detroit casinos are subject to both state and local taxes on their revenues minus winnings they pay out – the state tax rate is 8.1% and the local tax is 9.9%. The online gaming proposal would levy a state tax of 10% on internet gaming revenues minus winnings paid out.

### **Research**

Economists have studied the interaction between various forms of gaming, but research of online gaming is relatively sparse, due presumably to the relative newness of the technology and the until-recent prohibition of the activity. There is one known study of the relationship between online gaming and commercial casinos. Kahlil S. Philander estimated that an increase of one dollar in gross gaming revenue coincides with an estimated 28 to 30 cent decrease in commercial gaming revenue, representing a moderate substitution effect between the two types of gambling.<sup>1</sup>

No known research has estimated the interaction between online gaming and other forms of gambling, such as lotteries or pari-mutuel betting.

### **Analysis**

Because the research available examines only the interaction between commercial casino gambling and online gaming, this analysis is necessarily limited to the subuniverse of gambling revenues from those two sources. However, we can use this information to inform an analysis of two questions you've posed:

*Question 1: If we assume no net increase in gambling in Michigan if online gaming is authorized and everything else remains the same, what effect on revenues could the State of Michigan expect?*

Philander's work estimates that 28 to 30 cents of every dollar of online gaming revenue would have otherwise been spent at a casino. (For purposes of this analysis, we will use the midpoint of that range – 29 percent.) So in the

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<sup>1</sup> Philander, K. S. (2011). The Effect of Online Gaming on Commercial Casino Revenue. *UNLV Gaming Research & Review Journal*, 15(2). Retrieved from <http://digitalscholarship.unlv.edu/grrj/vol15/iss2/5>

aggregate, for every dollar spent at a casino prior to the introduction of online gaming, 29 cents will be spent online instead and the remaining 71 cents will continue to be spent at the casino. In addition, another 71 cents will be spent online (which, along with the 29 cents diverted from casino revenues totals the whole dollar of online gaming revenue). In short, 58.5% (100 divided by 171) of every dollar of revenue will be attributed to online gaming and 41.5% (71 divided by 171) will be from casinos, all else equal.

If we impose the assumption that there would be no net increase in gambling revenue after the advent of online gaming, it would be reasonable to assume that gamblers would choose the same mix of online vs. casino gambling. Using a starting value of \$100 of existing commercial casino revenue, we might expect to see a revenue pattern like the following:

#### **Gambling Revenue**

	Casino	Online	Total
Prior to legalization	\$100.00	\$0.00	\$100.00
After legalization	\$41.50	\$58.50	\$100.00
Net change (percent)	-\$58.50 (-58.5%)	\$58.50 (N/A)	<b>\$0.00 (0%)</b>

The corresponding tax revenues would be:

#### **Tax Revenues – State of Michigan**

	Casino	Online	Total
Prior to legalization	\$8.10	\$0.00	\$8.10
After legalization	\$3.36	\$5.85	\$9.21
Net change (percent)	-\$4.74 (-58.5%)	\$5.85 (N/A)	\$1.11 (13.7%)

#### **Tax Revenues – City of Detroit**

	Casino	Online	Total
Prior to legalization	\$9.90	\$0.00	\$9.90
After legalization	\$4.11	\$0.00	\$4.11
Net change (percent)	-\$5.79 (-58.5%)	\$0.00	-\$5.79 (-58.5%)

### Tax Revenues – State and Local

	Casino	Online	Total
Prior to legalization	\$18.00	\$0.00	\$18.00
After legalization	\$7.47	\$5.85	\$13.32
Net change (percent)	-\$10.53 (-58.5%)	\$0.00 (N/A)	-\$4.68 (-26%)

The above suggests that if there is no net increase in gambling and Philander's estimates are correct, there would be a net decrease in total tax revenues between online gaming and commercial casinos. This result is due to the fact that casino revenues are taxed at a higher (combined state and local) rate than online gaming would be. You will notice, however, the disparate effects on the City of Detroit as compared to the State of Michigan: the State would actually see an increase in revenue, while the City's revenue would absorb the full effect of the cannibalization of casino gaming by its online competition.

Note: The illustration above and the research findings upon which they are based should not be interpreted to mean that overall gambling will necessarily increase if online gaming is authorized. This exercise merely examines the subuniverse of online and casino gaming grouped together. We might, for example, consider where the additional 71 cents of online gaming in the above illustration is coming from – some or all of it may be coming from other sources of gambling apart from casinos.

*Question 2: How much net new gambling would online gaming have to produce in Michigan, all else equal, for there to be no net decline in tax revenues from gaming?*

Again, our assessment is limited to combined revenues from online gaming and commercial casino revenue. As illustrated above, tax revenues from the two sources might be expected to decrease in the aggregate if there is no net new gambling as a result of legalization due to the substitution effect and the differential tax rates.

For combined state and local revenues to be unaffected, combined online and commercial casino revenues would have to be approximately 35% higher than current commercial casino revenues are. Under this scenario the State would still see an increase and the City a decrease. Each governmental unit would be held harmless only if the State reimbursed the City for its loss.

### **Gambling Revenue**

	Casino	Online	Total
Prior to legalization	\$100.00	\$0.00	\$100.00
After legalization	\$56.08	\$79.06	\$135.14
Net change (percent)	-\$43.92 (-43.9%)	\$79.06 (N/A)	<b>\$35.14 (35.1%)</b>

### **Tax Revenues – State of Michigan**

	Casino	Online	Total
Prior to legalization	\$8.10	\$0.00	\$8.10
After legalization	\$4.54	\$7.91	\$12.45
Net change (percent)	-\$3.56 (-43.9%)	\$7.91 (N/A)	\$4.35 (53.7%)

### **Tax Revenues – City of Detroit**

	Casino	Online	Total
Prior to legalization	\$9.90	\$0.00	\$9.90
After legalization	\$5.55	\$0.00	\$5.55
Net change (percent)	-\$4.35 (-43.9%)	\$0.00	-\$4.35 (-43.9%)

### **Tax Revenues – State and Local**

	Casino	Online	Total
Prior to legalization	\$18.00	\$0.00	\$18.00
After legalization	\$10.09	\$7.91	\$18.00
Net change (percent)	-\$7.91 (-43.9%)	\$0.00 (N/A)	\$0.00 (0%)

If the State of Michigan were not willing to reimburse the City of Detroit for any of its lost revenue, then the only way the City would be kept whole is if commercial casino revenue were unaffected by the introduction of online gaming. If Philander's research is correct that there is a moderate substitution effect of approximately 29 percent, the only way that could happen is if online gaming creates 141 percent of net new gambling revenue in the state as compared to existing commercial casino revenue.





U.S. Department of Justice

Federal Bureau of Investigation

Washington, D. C. 20535-0001

November 13, 2009

Honorable Spencer Bachus  
Ranking Member  
Committee on Financial Services  
House of Representatives  
Washington, DC 20515

Dear Congressman Bachus::

I am writing in response to your letter to Director Robert S. Mueller, dated October 19, 2009, concerning your questions relating to Internet gambling. I will address these as you mentioned them in your initial correspondence:

- Does technology exist that could facilitate undetectable manipulation of an online poker game?

Yes, the technology exists to manipulate online poker games in that it would only take two or three players working in unison to defeat the other players who are not part of the team. Technically, the online poker vendors could detect this activity and put in place safeguards to discourage cheating, although it is unclear what the incentive would be for the vendor. It really comes down to a cost analysis for the vendor. How much money will I make or lose by detecting cheating and implementing the safeguards?

- Could technology be used to illicitly transfer or launder money in the guise of "innocent" participation in an online poker game, or the undetectable theft of money from one participant in such a game, by others acting in concert? If yes, to what degree?

Yes, online poker could be used to transfer ill gotten gains from one person to another, or several other people. Private tournaments exist on several online poker programs which would allow a subject to create a private game with his/her money mules. Once the game is created, the subject could raise the pot, to whatever maximum amount is allowed, and then fold before the hand is finished. This would allow the subject to transfer the money from his account to the mule account. This activity could repeat itself several times, virtually "washing the money." Once again, this activity could be detected by the vendors, but at what cost? Also, there are several ways to cheat at online poker, none of which are illegal. Teams of players could work in

unison, revealing to each other what cards they have in their hands. Based on the known cards, the team could use this knowledge to raise the pot. The players who are not part of the team would be at a distinct disadvantage because they do not have the knowledge of what cards are already in play. Several bots, software programs, have been created to play online poker. These bots are programmed to take in all the information about a given hand and use that information to formulate the chances of the bot having the winning hand. Most online poker sites have a specific section of their user agreement that bans bots from their poker rooms. Bots have a distinct advantage over real players in that they can use the processing power of the computer to determine the chances of winning.

- Does the Federal government have the ability in terms of qualified personnel and financial resources to regulate Internet poker if it is legalized?

FBI investigative resources are focused on our highest priorities, that being Counterterrorism, Counterintelligence, and Cyber threats to critical infrastructures.

- Do you believe the claims of vendors who say they have technology solutions that would validate the age of a potential player in an online poker game, or the physical location, beyond a shadow of doubt?

While the vendors may claim that they can validate age and location, they are more than likely relying on credit card information and geolocation to gather this information. Both can be spoofed. For age verification, the possession of a credit card is usually the only validation these sites require. Credit card numbers are easily compromised and can be bought by the hundreds on several "underground" websites. Therefore, the simple act of owning a credit card number does nothing to validate someone's age. For location verification, the vendors are more than likely going to rely on geolocation. While geolocation can be accurate when used to determine the physical country of residence, it becomes exponentially less accurate when determining the city or zip code. Additionally, the use of Internet Protocol (IP) address based information for geolocation allows for the manipulation of geolocation information. By changing the IP address information, someone can make it appear that their residence is in a different location.

- Has U.S. law enforcement discussed potential vulnerabilities of online poker with foreign counterparts? If so, what views have been expressed?

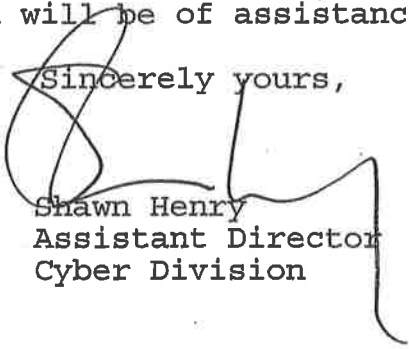
The FBI has not engaged in this discussion with our foreign partners.

- Please detail any known or alleged incidents of online cheating, particularly efforts by online casinos themselves, to manipulate the outcome of games using technology such as "pokerbots", for example.

While casino software could very easily be employed to manipulate games, the FBI has no data in this area.

I hope this information will be of assistance to you.

Sincerely yours,



Shawn Henry  
Assistant Director  
Cyber Division



## Pittsburgh ‘Bot’ Beats Top Poker Pro’s

*“...gambling people are worried that it may kill internet gambling...”*

**“Four of the best professional poker players in the world** spent most of January holed up at the Rivers Casino in Pittsburgh, losing...

When the 20-day tournament at Rivers came to an end Monday, **the humans had lost \$1.8 million...** computer scientists at Carnegie Mellon who built Libratus, celebrated the win...”  
([Bloomberg, 1/31/17](#))

### **Poker Analyst: ‘Number One Fraud Concern’**

- **Top Poker Player:** “It’s hard. **‘We just simply do not have the mental capacity to do it,’** he said.” ([Bloomberg, 1/31/17](#))
- **“Bots don’t have to be wildly skilled at poker to be profitable for their operators — and dangerous to the industry.** A program that can make modest profits by exploiting mediocre players may be worth it.” ([Bloomberg, 1/31/17](#))
- **Online Poker Analyst:** “If you’re an online poker operator, this is probably your number one fraud concern...” ([Bloomberg, 1/31/17](#))
- **Pittsburgh Computer Scientist:** “...people are worried that bots are going to be so good that they’re going to be had...” ([Bloomberg, 1/31/17](#))

### **Anonymous Groups Buy Poker ‘Bots’ To Cheat**

- “...Robot Shark Gaming that built AI programs for studying and playing strategic games... when a group of professional players approached him, offering to pay for software they could use in training. **Gibson was only given one person’s name, never met any of his clients in person,** and isn’t sure how many people were in the group... ([Bloomberg, 1/31/17](#))
- “The **anonymous pros** weren’t Gibson’s only clients. In one case, he said **someone paid him tens of thousands of dollars to spend about six months building a lightweight poker bot.** He didn’t ask much about how it would be used — he didn’t want to know — but the design pointed to a specific application.” ([Bloomberg, 1/31/17](#))

